Davis Brown Tax Law Blog

Calculating the Qualified Business Income Deduction Under Section 199A – Limitations to Avoid and Opportunities to Pursue – August 30, 2018

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Section 199A of the Internal Revenue Code was enacted on December 22, 2017, as part of the Tax Cuts and Jobs Act and provides for a deduction of up to 20% of income from certain domestic businesses operated as sole proprietorships, partnerships, S corporations, and certain trusts and estates. This post focuses on the mechanics of the Section 199A deduction, how it is calculated and what factors can influence its availability and limitation.

The calculation of the Section 199A deduction depends on a variety of factors and can be quite complex. The most significant factor is the taxpayer's taxable income. For those married persons filing jointly with taxable income equal to or less than the "threshold amount" of $315,000 ($157,500 for those taxpayers filing single), the calculation is fairly straightforward. Once a couple's taxable income exceeds $315,000, the Section 199A deduction is limited based on a number of factors and can be phased out entirely depending on the type of business.

Taxpayer's Taxable Income Does Not Exceed $315,000[1]

The first step in determining how to calculate a taxpayer's Section 199A deduction is to determine whether their income exceeds the threshold amount of $315,000. If it does not, the calculation is greatly simplified. A taxpayers' Section 199A deduction in such a case, is the lesser of these two figures:

1. 20% of the taxpayer's qualified business income ("QBI")[2]
2. 20% of the taxpayer's taxable income less their net capital gains

QBI is a term that involves some nuance and will be covered in an upcoming post. For purposes of this post, it is sufficient to know that QBI is generally the net amount of qualified income, gain, deduction, and loss from a domestic trade or business in which the taxpayer is an owner. As noted, the business must be a sole proprietorship, a partnership (including an LLC taxed as a partnership), an S-corporation, or certain types of trusts and estates. Importantly, QBI also does not include wages earned from a company as an employee. A simple example of the calculation is as follows:

Example 1

Adam and Bailey are married. Adam earned $500,000 in wages as an employee of an unrelated company in 2018. Bailey owns 100% of the shares of Bailey's Appliance Repair Service, an S corporation. Bailey's Appliance Repair Service generated $100,000 in net income from operations in 2018. The company paid Bailey $150,000 in

wages in 2018. Adam and Bailey had no capital gains or losses for 2018. Let's say Adam and Bailey's total taxable income for 2018 was $270,000.

Calculation of 199A Deduction

In this example, Bailey's Appliance Repair Service's QBI is the $100,000 in net income from operations. Because Bailey is the sole owner of the company, all of its QBI is attributed to her.

Taking 20% of the $100,000 of QBI gives us $20,000. We need to compare that amount to 20% of taxable income less any net capital gains. Here, taxable income is $270,000 and the couple had no net capital gains. 20% of $270,000 is $54,000. We compare $54,000 to the $20,000 figure and because $20,000 is less, that amount is Adam and Bailey's combined Section 199A deduction for 2018.

Taxpayer's Taxable Income Exceeds $315,000

In general, once a taxpayer's taxable income exceeds $315,000 ($157,500 for single taxpayers), their 199A deduction faces certain limitations. The proposed regulations under Section 199A provide a very detailed set of instructions for implementing these limitations. The exact mechanics are beyond the scope of this post, but a brief discussion of what factors influence these limitations can help the reader begin to understand how structuring their business affairs in a slightly different fashion can equal significant tax savings.

Once a taxpayer's taxable income reaches $315,000, the Section 199A deduction for a particular business is limited to the lesser of:

1. 20% of the QBI from that business
2. Or the greater of:
    1. 50% of the W-2 wages paid with respect to that business or
    2. 25% of the W-2 wages paid with respect to that business plus 2.5% of the unadjusted basis of qualified property for that business.

In the coming weeks, look for a post detailing the rules regarding the type and amount of W-2 wages that qualify for this calculation, along with a detailed definition of "unadjusted basis of qualified property for that business." For our purposes, it is sufficient to know that the W-2 wages paid must be related to the activity that generated the QBI of the business at issue and the property must be depreciable and similarly related to the activity that generated the QBI. An example will help illuminate this limitation.

Example 2

Alex and Betty are married. Alex owns several tracts of land that he manages and which are leased to local businesses. Betty does not earn any income. Alex's business is a sole proprietorship that generated $1,000,000 of QBI in 2018. The business paid no wages and the land does not constitute "qualified property," because it is not depreciable. Alex and Betty's combined taxable income is $980,000.

Calculation of 199A Deduction

Since Alex and Betty's combined taxable income exceeds the threshold amount of $315,000, certain limitations apply. Their 199A deduction is limited to the lesser of 20% of QBI or the greater of (1) 50% of the W-2 wages paid

or (2) 25% of the W-2 wages paid plus 2.5% of the unadjusted basis of qualified property. In this case, 20% of QBI is equal to $200,000 (20% x $1,000,000). Since the business paid no W-2 wages, however, the Section 199A deduction is limited to $0 (50% of $0 = $0 and 25% of $0 + $0 = $0).

In the simple example above, we can see that if Alex's business had paid him W-2 wages, Alex and Betty would have been entitled to a Section 199A deduction. Similarly, the purchase of depreciable property (either in isolation or in combination with the payment of W-2 wages) could have increased the Section 199A deduction as well. Taxpayers should take note of the availability of these strategies when making capital investment decisions and determining the method by which they extract value from their company.

Specified Service Trades or Businesses

Another important limitation on the Section 199A deduction applies only to certain trades or businesses known as specified service trades or businesses (SSTBs).[3] In addition to the limitations illuminated in Example 2, if a taxpayer's taxable income exceeds $315,000, further limitations apply if the business at issue is an SSTB. Once the taxable income threshold is exceeded, only a certain percentage of the QBI, W-2 wages, and qualified property can be used in calculating the Section 199A deduction.

Those attributes of an SSTB are completely phased out from use in the Section 199A deduction calculation when taxable income reaches $415,000 ($207,500 for a single taxpayer). It is imperative that taxpayers determine whether one or more of their businesses is likely to be considered an SSTB, as these rules offer planning opportunities. Under the right circumstances, for example, one line of business may be able to be spun-off from an existing company via a tax-free reorganization to lessen the impact of the SSTB limitations.

Under certain circumstances, different trade or business with commonalities in ownership and scope can be combined and treated as one trade or business for purposes of the Section 199A deduction.[4] Given the limitations illustrated in Example 2, taxpayers may be able to take advantage of these aggregation rules to increase their Section 199A deduction.

Business Planning

This was a brief overview of the types of factors that can affect the availability and amount of the Section 199A deduction. The calculation can be quite detailed given the right set of circumstances and taxpayers are urged to contact an attorney to assess the availability of this powerful deduction and to discuss planning opportunities that may enhance its impact on their bottom line.

1 This Article will discuss the relevant limitations based on married persons filing a joint return, unless otherwise noted.

2 Under Section 199A, 20% of qualified income from REITs and publicly-traded partnerships are added to the 20% of QBI figure, but they have been omitted from this article for ease of reading.
3 For a discussion of what types of businesses are considered SSTBs, see the article written by Davis Brown attorney Bill Hanigan.
4 Stay tuned for an article by Davis Brown attorney Mitch Plimmer discussing the circumstances in which the aggregation rules can be applied.

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